Financial Reporting Council

Effective Company Stewardship

Enhancing Corporate Reporting and Audit

FRC

Effective Stewardship

This paper considers how the effectiveness of the stewardship role of Boards and Audit Committees can be enhanced through corporate reporting and audit. We welcome responses from all our stakeholders and particularly seek the views of institutional investors and directors with stewardship obligations. This paper does not focus on the crisis in financial services. Instead, it looks forward and covers companies in all sectors.

The deadline for responses is: 31 March 2011.

Responses should be sent to:
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The FRC would like to thank all those who have contributed ideas to this discussion paper, in particular members of the advisory group which was established in July 2010 to provide advice on the issues covered in this paper. The ideas and recommendations contained in the paper are those of the FRC.

What happens next?

The FRC will evaluate the responses to this discussion paper and hold a stakeholder conference on the key issues emerging from the consultation. We will also pilot a number of the initiatives proposed in the discussion paper. Where relevant, we will consult further (including a regulatory impact assessment) on specific proposals that we decide should be taken forward.

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CHAPTER ONE: **INTRODUCTION**

The modern company, formed in the Victorian era and developed since, gives Boards of directors the stewardship responsibility for investors' money. It has enabled enterprises to raise debt and equity and a vibrant capital market to develop. However, the financial crisis and global recession placed unprecedented stress on companies and it is timely to ask whether the worst financial crisis in eighty years has exposed any shortcomings across all large companies, not just in financial services.

Many argue that the crisis demonstrates the need for reform. Others point out that companies in the non-financial sectors came through the global recession better than expected given its speed and depth. Furthermore, the UK equity market excelled in funding companies to recapitalise and weather the storm.

What is stewardship?

- Investors delegate control to Boards and receive reports about how that control is exercised. They expect the Board to provide strategic direction; to ensure its executives implement that strategy; and to report openly and honestly so that they can assess the progress being made.
- Investors' trust in the Board is underpinned by the UK Corporate Governance Code the aim of which is 'to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company'.
- Whilst Board directors are the principal stewards of investors' interests, many individual investors and pensioners also often expect fund managers to act on their behalf and are reliant on them being active as stewards of their investments.

This system is dependent on the provision of robust and reliable information by companies to investors and on audit assurance of that information.

The UK Government, the EU and others are already considering how the risk of such a crisis occurring in the future can be reduced and whether there are lessons that can be learned of general application. The Department for Business, Innovation and Skills has consulted on the re-introduction of an Operating and Financial Review (OFR) and on how to develop a long-term focus for corporate Britain. This paper is the FRC's contribution to these debates, focused on reporting and audit.

The FRC has already undertaken enquiries into the lessons to be learned about governance from the financial crisis. As a result, it revised the UK Corporate Governance Code (the "Code") and issued the Stewardship Code for Institutional Shareholders. It has also issued guidance to auditors on assessing whether a business is a going concern, on audit firms' governance and on auditor independence.

However, lessons go wider. The financial crisis highlighted the importance of the identification, analysis and management of risk. That is not only true in financial services. Companies in all sectors still get into trouble because of failures in this respect. Our aim is to reduce the likelihood that the message will be forgotten – as it has been after past crises – by increasing transparency in the way that directors report on their activities, including their management of risk.

We want to see the example set by the best in corporate reporting adopted across the market so that Annual Reports, including audited financial information, deliver greater value to investors and serve the public interest better.

Our aim is to see:

- Higher quality narrative reporting, particularly on business strategy and risk management;
- More widespread recognition of the importance of Audit Committees and, therefore, greater emphasis on their contribution to the integrity of financial reporting;
- Greater transparency of the way that Audit Committees discharge their responsibilities in relation to the integrity of the Annual Report, including oversight of the external auditors;
- More information about the audit process, both for Audit Committees and for investors, and a broadening of the scope of the auditor's responsibilities; and
- More accessible Annual Reports through the use of technology.

As these proposals are developed, the FRC will consult on whether they should apply to all listed companies, to those in the FTSE 350, or to some other grouping (such as those having systemic significance).

The proposals build on existing foundations and are not, in our view, over-prescriptive, but on that we welcome views. They also take account of the undesirability, in the context of promoting economic prosperity, of building a regulatory framework that eliminates the risk of failure.

CHAPTER TWO:
KEY RECOMMENDATIONS

1. Directors should take full responsibility for ensuring that an Annual Report, viewed as a whole, provides a fair and balanced report on their stewardship of the business.

2. Directors should describe in more detail the steps that they take to ensure:

    - the reliability of the information on which the management of a company, and therefore directors' stewardship of the company, is based; and

    - transparency about the activities of the business and any associated risks.

3. The growing strength of Audit Committees in holding management and auditors to account should be reinforced by greater transparency through:

    - fuller reports by Audit Committees explaining, in particular, how they discharged their responsibilities for the integrity of the Annual Report and other aspects of their remit (such as their oversight of the external audit process and appointment of external auditors); and

    - an expanded audit report that:

        - includes a separate new section on the completeness and reasonableness of the Audit Committee report; and

        - identifies any matters in the Annual Report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit.

4. Companies should take advantage of technological developments to increase the accessibility of the Annual Report and its components.

5. There should be greater investor involvement in the process by which auditors are appointed.

6. The FRC's responsibilities should be developed to enable it to support and oversee the effective implementation of its proposals.

7. The FRC should establish a market participants group to advise it on market developments and international initiatives in the area of corporate reporting and the role of assurance and on promoting best practice.

CHAPTER THREE: NARRATIVE REPORTING

Key Points:-

- **The Annual Report should communicate high quality and relevant narrative and financial information to the market.**
- **Directors should take full responsibility for ensuring that an Annual Report, viewed as a whole, provides a fair and balanced report on their stewardship of the business.**
- **Directors should describe in more detail the steps that they take to ensure:**
  - **the reliability of the information on which the management of a company, and therefore the directors' stewardship, is based; and**
  - **transparency about the activities of the business and any associated risks.**
- **Companies should take advantage of technological developments to increase the accessibility of the annual report and its components.**

At a time when business and the provision of finance is becoming increasingly complex and globalised, investors and capital markets require reliable in-depth information about the business of a company, its strategy, the risks to its success and the ways in which it manages those risks.

Most of this information cannot be defined in accounting standards and reduced to individual numbers. Forward looking information about how markets are expected to develop and the consequent strategy can only be communicated in a narrative manner.

Companies are required by law to prepare Annual Reports, including audited accounts, and these are the mechanism by which management report on the stewardship of the company and its assets to investors and other users. Annual Reports then provide the underpinning to other communications by companies – such as interim management statements, market sensitive information, and investor presentations. Given the important role that they play in the corporate reporting framework, it is essential that Annual Reports are relevant and present an accurate, coherent and balanced picture of the business and its prospects.

The manner in which information is provided is not the only consideration. The requirements of securities regulators ensure that investors are provided with market sensitive information speedily[1]. An informed investor should not, therefore, be surprised by any information contained in the published Annual Reports and accounts of listed companies.

The Annual Report should communicate high quality and relevant narrative and financial information to the market.

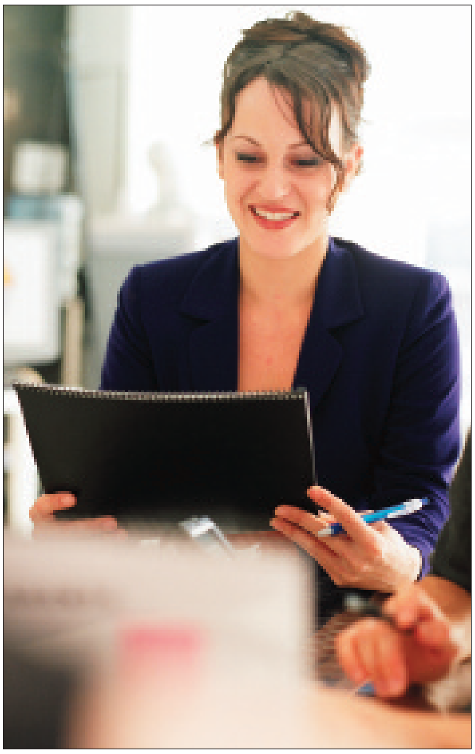
Significant changes have taken place in recent years in narrative reporting as companies have responded to the introduction of the Business Review requirements of the Companies Act 2006, Corporate Governance

[1] See, for example, the Regulated Information Service ('RIS') operated by the Financial Services Authority to support the requirements of the Listing Rules and other regulations.

disclosures required by the Code and pressures from stakeholders to extend the commentary on environmental matters.

Some companies have produced Annual Reports containing exemplary narrative reporting. However, this is far from universal and best practice has not become the norm. Indeed, too many Annual Reports do not cover all of the necessary topics sufficiently well to constitute an adequate report on the Board's stewardship of the company.

The FRC recently concluded that it was necessary to introduce a new disclosure requirement into the Code because companies have provided inadequate explanations of business models and strategy. The Financial Reporting Review Panel (FRRP) has raised the adequacy of disclosures relating to principal risks and uncertainties with a number of companies and seen deficiencies in descriptions of a company's business model. Concerns have also been raised about the reporting of environmental matters and of how capital is managed.



The Accounting Standards Board (ASB) found poor information in a number of areas relating to the requirements of the Companies Act 2006:

	% non-compliant	% falling short
Business description	6	52
Strategy	8	44
Principal risks[2]	0	66
Performance and position	4	20
Trends and factors	6	56
Corporate Social Responsibility	12	34
Contractual and other arrangements	12	52
Financial KPIs	6	34
Non-financial KPIs	32	20

[2] It is notable that, whilst all companies formally complied with this reporting requirement, it was the area where they did so in the least informative manner.

This overview, which is supported by other studies[3], shows that companies in general need to improve the quality and relevance of their narrative reporting, whilst also decreasing its length and use of legalistic 'boilerplate' disclosures.

The FRC believes that:

- Regulation, combined with guidance and compliance monitoring, must promote the production of Annual Reports and accounts that contain information that is relevant to investors and other users, rather than allowing or encouraging boilerplate.
- Companies should provide information in a user-friendly and accessible manner[4]. To achieve this, statutory and regulatory requirements need to be amended to permit:
    - companies to decide how and where they provide particular information; and
    - the Annual Report and accounts to be posted on a company's website, rather than produced in print.

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[3] Recent studies have commented on the ever increasing content of Annual Reports and accounts.

- Deloitte recently reported [Swimming in words: Surveying narrative reporting in Annual Reports] that Annual Reports and accounts for listed companies are 41% longer than in 2005 and, on average run to over 100 pages.
- The structure of the Annual Report and accounts has also raised concern. Having been created in piecemeal steps by a wide range of bodies, there are overlapping requirements to provide narrative and numerical amounts in different parts of an annual report, and barriers to how companies can present items in a logical sequence. As some of the requirements are not aligned perfectly, this leads to inconsistent information being reported in two or more areas of the annual report and accounts. The result is confusing to investors and undermines confidence in the reliability of the overall document.
- Black Sun commented [Black Sun Rethinking Reporting: Annual analysis of FTSE Corporate Reporting Trends, 2009] that over 40% of companies fail to identify any non-financial KPIs and that whilst the quantity of corporate social responsibility narrative may have increased, the quality of that material is questionable particularly as most do not demonstrate how it is an integral part of their business. They also observe that the majority of risk reporting is a list of boilerplate disclosures which do not provide a meaningful discussion of potential impacts or mitigation strategies and that most companies still approach the way they communicate on governance as a box ticking exercise. Deloitte [Right to the End: Surveying financial statements in annual reports] found that descriptions of principal risks are too generic, that there is a lack of detail on trends and factors, and that there are too many KPIs and no explanation of the link between strategy and objectives.

[4] The following sequence might better facilitate a dialogue with investors and stakeholders:

- Vision and objectives
- Market opportunity and position relative to market
- Business model
- Strategy for achieving objectives
- Required resources including people and other forms of capital
- Principal risks and uncertainties
- Performance against key performance indicators
- Financial position and historical financial and other performance
- Governance and remuneration arrangements
- CSR matters could be addressed within the above topics or dealt with separately.

Directors should take full responsibility for ensuring that an Annual Report, viewed as a whole, provides a fair and balanced report on their stewardship of the business.

The narrative report, like the financial statements, should reflect a Board's considered view of the information that investors and other users of Annual Reports need. It should not be promotional in nature, a fault seen in some narrative reporting.

To achieve this, the FRC believes that an Annual Report should explain, in a manner that is clear and understandable to users, the company's business, strategy and prospects and the risks and uncertainties involved in the course being pursued. Directors should be responsible for ensuring that each element of an Annual Report, as well as the Annual Report in aggregate, should meet the test of being balanced and fair.

In order that such a regime can be responsive to changing regulatory and market developments, a framework should be established through a Narrative Reporting Standard issued by the ASB, rather than through regulation. Such a Code could set out the principles governing the preparation of Annual Reports (including narrative reports) and establish the responsibility of directors for ensuring that Annual Reports are balanced and fair. The role of the auditor in relation to this material is addressed in chapter four.

Directors should describe the steps that they take to ensure the reliability of the information on which the management of a company, and therefore directors' stewardship of the company, is based and transparency about the activities of the business and any associated risks.

A recurring theme in post crisis analysis has been the importance of how risk is identified and managed. It is striking that the importance given to managing risk tends to track the state of the economic environment – in difficult times, the risks that companies face occupy senior management and the Board; whilst in good times, the pursuit of growth takes centre stage, often, as we have seen, without an equivalent consideration of the risks involved. Nor are all the lessons of previous economic crises learned so that the errors of one generation are avoided by the next.[5]

It is not possible for senior management of larger companies to have personal knowledge of all the activities of their business, including the risks arising from those activities. An information gap will always exist between those actually handling particular business activities and their directors. To address this, directors need systems that will ensure that they are given enough relevant information about the business to understand the risks it runs and how these risks are changing. Only then will they be able to discharge their stewardship responsibilities to shareholders.

This is the foundation on which delegated management is built and so, if users are to have confidence in the directors' stewardship, companies should explain the steps that they take to ensure the reliability of the information on which the management of a company, and therefore directors' stewardship of the company, is based. Any such explanation should include matters such as:

[5] Lessons learned include the risks of borrowing short and lending long (in the 1970s secondary banking crisis), the loss of risk control caused by 'slicing and dicing' in the pursuit of intermediary costs (which led to the Lloyds of London insurance market collapse in the late 1980s); and the market losses arising from unrealistic and unsupported business projections (the 'Dot Com' crash in the early 2000s).

- the principles on which the internal reporting regime, particularly in relation to the principal risks arising from the company's activities, is based;
- the steps taken to establish a clear framework of management and reporting, under which specific individuals have responsibility for particular aspects of the company's activities;
- the role of internal audit;
- the extent and frequency with which the effectiveness of the system is tested; and
- the effectiveness of the external assurance arrangements.

The challenge is to provide that explanation in a way that is accessible to users and efficient in terms of the cost and burden on companies[6].

Companies should take advantage of technological developments to increase the accessibility of the annual report and its components.

Recent studies and market commentary have expressed concern at the increasing length of Annual Reports and at the difficulty in finding specific information within the report. Listed companies now make their Annual Reports and accounts available to all stakeholders on their web sites and send them in hard copy to shareholders who request them.

However, not all companies have made their Annual Reports searchable on the web. The most significant technology available is eXtensible Business Reporting Language (XBRL) [http://www.xbrl.org], a tagging system that enables investors and other stakeholders to find more quickly specific items of data in Annual Reports.

It has already been mandated in other markets, notably the USA [http://www.sec.gov/spotlight/xbrl.shtml].

Access to the information in Annual Reports would be improved if companies were to:

- provide access to Annual Reports and accounts through the web in a form that enables them to be searched quickly and easily;
- adopt common reporting languages such as XBRL if that would facilitate engagement[7]; and
- be relieved of the burden of producing Annual Reports and accounts in printed form which is a drain on the resources they have for developing better methods.

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6 The FRC is keen to avoid replicating the costs that have arisen from the US Sarbanes-Oxley Act

7 As it is at the heart of the iXBRL tax filing requirements recently introduced by HMRC and is a permitted format for filings at Companies House, XBRL provides a practical option for increasing the accessibility of information in Annual Reports for the benefit of investors and other users.

CHAPTER FOUR:
ASSURING INTEGRITY

Key Points:-

- Investors need to have confidence in the integrity of the narrative and financial information they receive in the Annual Report.
- Confidence in corporate reporting should be reinforced by a more effective and transparent assurance regime that involves:
  - a quality audit of the financial statements;
  - the revision of auditing standards to expand the nature and extent of the report provided by auditors to Audit Committees;
  - fuller reports by Audit Committees explaining how they have discharged their responsibilities for the integrity of the Annual Report and other aspects of their remit (such as, their oversight of the external audit process, and the appointment of the external auditors);
  - an expanded audit report that includes:
    - a separate new section on the completeness and reasonableness of the Audit Committee report; and
    - identification of any matters in the Annual Report that the auditors believe are incorrect or inconsistent, with the information contained in the financial statements or obtained in the course of their audit.
- There should be greater investor involvement in the process by which auditors are appointed.

The previous chapter set out the changes that we propose to address the needs of users of Annual Reports in the modern and highly complex financial and investment environment. It is clearly essential that investors and other users have confidence in corporate reports – this is particularly true if shareholders are to discharge their stewardship responsibilities effectively, make sound investment decisions, and thereby ensure the effective operation of the capital markets. This chapter considers how users can be assured of the integrity of such Annual Reports.

At the inception of corporate reporting in the 19th Century, the audit was developed to address the issues of that time – principally whether past transactions and their impact on assets and liabilities were correctly recorded in published financial information. Since then, technology has materially changed financial reporting. With computers processing transactions and allocating sale proceeds in accordance with accounting requirements, numerical issues are less problematic.

Recently accounting has also moved away from historical cost. Instead, some assets and liabilities are booked at their market value when the accounts close, rather than at cost. This change has enhanced the value of accounts – historical numbers are easy to obtain but often meaningless – but has increased the complexity of accounting standards and requires preparers and auditors to exercise significantly greater judgement.

As a result of these changes, the reliability of financial statements is now more dependent on:

- The effectiveness of the systems that a company has in place to monitor the activities of the business and the risks associated with those activities.
- Establishing the current values of assets and liabilities.
- The quality of the external audit, including, for example, whether it has properly considered:
  - the appropriateness of the accounting policies adopted; and
  - the methods and the judgements made in valuing assets and liabilities.
- The approach taken by all responsible for the financial statements to achieve a 'true and fair' presentation of the financial position of the company.

Users and, in particular, investors are increasingly aware of the importance of these factors. If they are to have confidence in the way financial statements are prepared, there must therefore be appropriate disclosure of the approach taken to these matters by the company and, where appropriate, by the auditors, and that disclosure must be subject to an effective and transparent assurance regime. Above all, to be useful, disclosure must be tailored to the position of the particular company – and must not descend into boilerplate, uninformative text. These are all key issues for Audit Committees in their work with management and to ensure good quality audit.

A quality audit of the financial statements

It is clear from the research that the FRC and others have undertaken that users recognise that an audit that is undertaken in an independent and thorough manner provides effective and objective assurance about a company's financial statements.

However, the recent financial crisis has given rise to considerable concern about the role and value of audit in relation to the financial services sector. Some important questions have been asked about the effectiveness of audit in circumstances where banks failed shortly after their financial statements received unqualified audit opinions. Those questions include whether the risks and uncertainties facing the banks were adequately described and/or it was appropriate for the financial statements to be prepared on a going concern basis. Concerns were also raised about the effects of accounting standards.

Under current company law and standards the auditor amongst other things addresses:

(i) whether the financial statements present a true and fair view of the financial health of the company at the balance sheet date; and

(ii) that it was reasonable for the directors to prepare the accounts on a going concern basis - i.e. that the company would be able to pay its debts as they fall due for the next twelve months.

No forward-looking analysis can be proof against the impact of unforeseen events, and so the auditors' views on the directors' going concern statements cannot provide as much assurance as auditors give with respect to the financial statements. However, questions do have to be asked when a company fails shortly after the audit has been completed.

Whilst we have found that audit work could have been more effective if auditors had shown more scepticism, we have established no circumstances where financial statements were materially misstated: rather corporate and financial reporting was overtaken by exceptional market conditions. During the financial crisis, the analyses that were considered reasonable at the time the report and accounts were finalised became rapidly obsolete as markets deteriorated, and the requirements of the listing regime that were intended to ensure that markets were kept properly informed of such developments proved inadequate to address the exceptional circumstances that arose. Audit, by itself, could not have prevented the collapse of the credit markets. That could only have been achieved if action had been taken by those responsible for macro economic affairs and prudential regulation.

In relation to audit's future role, we believe there is a case for improvements to audit practice so audit can contribute more to the identification of emerging issues while there is still time to take remedial action.

The FRC is particularly keen to ensure that the right environment is created for increased auditor scepticism when assessing material assumptions and estimates. Audit Committees have an important role to play in creating the appropriate environment for the audit team to challenge material assumptions and estimates in an effective way and to communicate their views in a forthright and constructive manner.

Audit Committees are likely to want to be convinced that key judgements are supported by a greater degree of rigour and analysis in challenging economic environments and to consider how such matters have been explained in the Annual Report. As part of this process they should set the appropriate expectations on the audit team and management.

Clearly the auditor needs to have the capability of responding to such expectations. The effective exercise of professional judgement is fundamental to the quality of every audit and it is required at numerous stages during an audit[8]. If auditors are to exercise that professional judgement effectively, they must approach issues such as these with an appropriate mindset – a mindset that includes professional scepticism[9]. Such scepticism would be enhanced by greater transparency, with the assessments made by auditors being open to effective challenge by the Audit Committee and investors.

We propose, therefore, that the standards governing the provision of reports by auditors to Audit Committees (such as ISA (UK & Ireland) 720) should be enhanced to ensure that they provide the information that is necessary to enable committees to understand fully the factors that auditors have relied upon in exercising their professional judgement in the course of the audit and, in particular, in reaching their audit opinion. These are likely to include, at a minimum, the auditors' views on:

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8 Professional judgement is required, for example when:

- assessing whether and, if so, how a company's financial statements may be vulnerable to misstatement;
- deciding the levels of materiality that are appropriate;
- reviewing the quality of the accounting systems and the effectiveness of the control environment, including risk management;
- reaching conclusions on the appropriateness of the accounting policies;
- evaluating the reasonableness of management's approach to estimates and valuations (including impairments of tangible and intangible assets);
- assessing the quality of management's disclosures in the Annual Report;
- reviewing the approach taken by management to issues raised by auditors in the course of the audit; and
- considering the meaning of "reasonable assurance" in the context of a specific audit and assessing the sufficiency of the audit evidence available to support an audit opinion.

9 Professional scepticism goes to the heart of auditors' judgement and audit effectiveness. Two consultations are already taking place which address this issue:

- The FSA and the FRC issued a joint consultation paper on the importance of professional scepticism in audits of financial services firms and how that can be enhanced, particularly when auditing assets valued on a fair value basis.
- The APB and POB have issued "Auditor Scepticism – Raising the Bar", which examines whether more needs to be done generally to promote and develop professional scepticism in auditors.

These papers raise questions about the need for enhancements to professional development, to auditing standards, and to the way professional scepticism is addressed in the recruitment, development and retention of audit personnel.

- the effectiveness of the company's controls (including their assessment of the risks arising from the company's business model) and how they have been tested, including the extent of the testing undertaken by the auditors as part of their agreed audit process;

- the judgements made in the audit plan about what is of material significance and the implications of those judgements for the level of assurance provided by the audit;

- the appropriateness of the accounting policies (viewed individually and in aggregate);

- the valuations of the company's assets and liabilities provided by management (with particular reference to those that are significant to the financial statements); and

- any other matters identified in the audit plan or by the audit committee as material to the proper presentations of the company's financial position.

A greater awareness of such matters would have four benefits. First, the discipline of providing such reports should enhance the quality of the auditor's exercise of professional judgement. Secondly, it would increase the transparency of the audit process to the audit committee. Thirdly, it would help the audit committee form its own view of the appropriateness of the presentation of the company's financial performance in the financial statements. And, fourthly, it would provide important information to the audit committee when deciding what information to include in its report.

Auditors who are independent of their client, acting without fear of dismissal for being challenging

Auditor objectivity, integrity and independence are key ingredients if investors are to have confidence in the reliability of financial statements. The Auditing Practices Board (APB) has recently concluded a full review of the Ethical Standards that auditors must comply with. That review focused particularly on whether auditors should provide some or any non-audit services.

The APB concluded that Audit Committees should exercise greater oversight over the non-audit services that auditors provide to the company they audit. Changes to the reporting regime have therefore been announced to reinforce Audit Committee responsibility for such services and improvements are being made to the regime for reporting such fees in the Annual Report.

We will keep the effectiveness of these changes under review and strengthen them if necessary.

Co-operation between regulators and auditors

One of the lessons learned from the financial crisis is that all relevant information should be made available to those responsible for regulatory oversight. In the financial services sector, the FRC is working with both the Bank of England and the Financial Services Authority (FSA) to develop the procedures and practices needed to facilitate the two way dialogue between supervisors and regulators, and audit firms. Consideration may also need to be given to establishing lines of communication between auditors of companies operating in other sectors and relevant regulators.

Fuller reports by Audit Committees explaining how they have discharged responsibilities for the integrity of the Annual Report and other aspects of their remit (such as their oversight of the external audit process and the appointment of the external auditors)

The role that an Audit Committee performs on behalf of the Board is set out in the Corporate Governance Code and, in summary, is to oversee the integrity of a company's financial affairs (from the effectiveness of its internal control regime to the fair presentation of the company's financial position in its Annual Report).

When the original corporate governance code was first introduced, the focus of Audit Committees (and auditors) was almost exclusively on the statutory financial statements. However, there has since been a raft of further material that, by legislation or regulation, companies are required to include in their Annual Reports. In addition, the complexity of accounting standards has led companies to include extensive material to support the information now contained in financial statements. Such disclosures increasingly include significant statements of belief and explanations about the future, both of which are made by management.

Much of the information disclosed is important to many categories of users (and to shareholders and investors in particular) and has the potential to affect materially the apparent financial performance of a company. However, it is not subject to any form of independent assurance beyond the limited requirements of the external audit.

Some have suggested that auditors should provide an additional and separate report setting out their views on these matters. However, the provision of such information is clearly the responsibility of directors and the training, skills and experience of auditors would need to be substantially enhanced if this approach were to be pursued. More importantly, the proposal that auditors should play such a substantive role compromises a fundamental principle of stewardship – namely, that the directors and management are exclusively responsible for the management of a company, including the use to which its assets are put and the liabilities that it incurs (subject only to the overarching rights reserved to the shareholders).

Instead we propose that Audit Committees report on the approach that they have taken to the discharge of their responsibilities, including describing in such terms as they consider appropriate, having regard to the commercial interests of the company concerned:

- The key areas of sensitivity or risk, including the choice of accounting policies, that they identified to the integrity of the Annual Report, including the financial statements, and how they arranged for those to be addressed;
- Any matters of material significance identified by the auditors in their report to the Audit Committee that are not addressed elsewhere in the Annual Report and which, in the directors' view, should be known to users if the Annual Report, taken as a whole, is to be fair and balanced;
- The steps that they took to assess the effectiveness of the audit[10];
- The policies that they adopted in relation to the provision of non-audit services to avoid the independence of the company's auditors being compromised;

[10] This would include:

- establishing whether the auditor met the agreed audit plan, understanding any changes, and the work undertaken to address any changes in perceived audit risks.
- considering the robustness and perceptiveness of the auditors' handling of key accounting and audit judgements, responding to questions from the audit committee and their commentary on the systems of internal control.
- obtaining feedback about the conduct of the audit from key personnel involved within the company, and
- reviewing the auditor's management letter, the manner in which any recommendations have been complied with and, where they have not been complied with, the reasons for management not having done so.

- The process by which they reached their recommendation to appoint or reappoint (as the case may be) the company's external auditors and the reasons for that recommendation; and
- The nature of any dialogue that they may have had with investors in relation to any material audit related issues (not covered elsewhere in their report).

Such a report by the Audit Committee would support the confirmation by the Board of directors that the Annual Report properly and fairly describes the business and its financial performance.

An expanded audit report

The FRC also welcomes views on whether an expanded audit report should be the final piece of the jigsaw that is necessary to give users confidence in modern day corporate reporting.

Users of financial statements have become increasingly aware that the matters that determine the scope and effectiveness of the audit and which are therefore important to the auditors in reaching their opinion are not expressly addressed in the audit opinion. The audit opinion contains nothing more than a pro-forma statement about the auditing and ethical standards that the auditor has complied with, and does not relate those standards to the actual work that has been done in the course of the particular engagement. Nor does the audit committee report on such matters. As a result users lack the information to enable them to assess the extent to which it is appropriate for them to rely on the financial statements.

It would not be appropriate to dictate by detailed regulation the information to be provided to meet users' needs – not least because different information will be appropriate for different companies and because some users will attach importance to particular information. Nor would it be appropriate to dictate by whom such information should be provided.

However, if our proposals are implemented (so that auditors provide a report to a company's Audit Committee, and Audit Committees report on the approach that they have taken to the discharge of their responsibilities), auditors should be required to report on the completeness and reasonableness of the audit committee report and, if necessary, set out any further information required to achieve that outcome. That would assure users that they had been provided with a comprehensive report on the matters that the auditors considered important in the course of their audit and in reaching their audit opinion.

A further area where auditors can provide a measure of assurance relates to those matters, other than the financial statements, contained elsewhere in the Annual Report. For the reasons discussed above, it would not be appropriate to require auditors to provide a separate report on such matters – but there is no reason why they should not be required to report, based on the work that they have done in the course of their audit, whether they are aware of any facts or matters in the Annual Report that are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit.

There should be greater investor involvement in the process by which auditors are appointed.

We recognise that, although shareholders confirm auditor appointments, management is perceived to determine the appointment (or re-appointment) and remuneration of auditors and that, therefore, auditor independence is compromised. In fact the appointment of auditors is overseen by the Audit Committee. This is appropriate. They are in a good position to ensure the process is properly run.

However, there is a case for the independence of the decision to be reinforced by the Audit Committee seeking greater shareholder involvement. In such an approach Audit Committees should be required either:

- to report on the process by which they reached their recommendation to appoint or re-appoint (as the case may be) the company's external auditors and the reasons for their recommendation; or

- to discuss with a number of principal investors the approach to be taken to the appointment or re-appointment of its auditors, including the merits or otherwise of putting its audit out to tender and then report on that consultation to shareholders generally.

Safe Harbour

The proposals discussed in this paper will result in additional requirements on directors, officers and auditors of companies. Some of those requirements may involve forward looking statements of belief or judgement. As a result, directors and officers of companies, including their auditors, may seek some form of "safe harbour".

To facilitate acceptance of its proposals, the FRC would support the provision of a "safe harbour" defence to directors, officers and auditors to the extent that they make or give assurance in relation to forward-looking statements, and provided that such statements or judgements were not made recklessly, dishonestly or fraudulently.

chapter5

CHAPTER FIVE:
FOSTERING QUALITY IMPROVEMENTS

Key points:-

- **The FRC's responsibilities should be developed to enable it to support and oversee the effective implementation of its proposals.**

- **The FRC should establish a market participants group to advise it on market developments and international initiatives in the area of corporate reporting and the role of assurance and on promoting best practice.**

To ensure that its proposals can be implemented effectively, the FRC believes that its powers need to be reviewed to reinforce its effectiveness and independence and to enable flexible, real-time intervention in the interests of investors and the effectiveness of capital markets.

Monitoring and enforcement

The FRRP and the Audit Inspection Unit (AIU) play important roles in assessing the quality of application of Accounting and Auditing Standards. Both Operating Bodies have an approach that is founded on continuous improvement supported by intervention where a significant failure is identified.

The FRRP reviews the accounts of some 300 companies per year and writes to companies where it appears that some form of non-compliance may be present. Where more difficult issues are identified that cannot be resolved simply through correspondence, company directors are invited to meet the FRRP in person. Many issues are resolved through undertakings to improve disclosures in the next set of accounts, but on occasions a wider group of FRRP members with current market experience will be created to assess an individual issue. The FRRP publishes the results of its work on an annual basis identifying areas for improvement [The Financial reporting Review Panel's Annual report 2010[11]].

The AIU inspects some 100 public interest entity audits each year. A key focus of an AIU inspection is to assess the quality of evidence auditors have to support their key judgements and to understand how audit firms have complied with auditing and ethical standards. A report is sent to each audit firm inspected which includes undertakings given by the firm to make improvements to the quality of future audits. The AIU publishes reports on the results of its work each year, including specific reports on the work of individual audit firms[12]. In addition the AIU provides confidential reports on individual engagements which audit firms provide to the directors of the entities concerned. Some 175 reports on individual audits have been issued in the last two years the findings of which will have contributed to Audit Committees' assessment of the effectiveness of their audit arrangements.

The FRC believes that:

- The FRRP's remit should be extended to cover the whole of the narrative content in Annual Reports and accounts; and

- The AIU's supervision should extend to the auditor's consideration of the narrative content in Annual Reports.

It also believes that consideration should be given to how, in the event of a corporate failure, a review might be carried out of that company's governance, accounts, and audit to ensure lessons, where appropriate, are learned and to ascertain whether further investigations or regulatory actions are necessary.

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11 http://www.frc.org.uk/frrp/press/pub2349.html
12 http://www.frc.org.uk/pob/audit/firmreports0910.cfm

Thematic studies to guide best practice

The FRC and its operating Boards have published ad-hoc thematic studies designed to highlight generic deficiencies and lead the development of best practice.

Recent studies of accounting topics have covered impairment assessments [FRC Review of Goodwill Impairment Disclosures, October 2008[13]] triggered by reduced growth expectations, and mergers & acquisitions [FRC study: Accounting for acquisitions, January 2010[14]] triggered by forecasts of an upturn in M&A activities that is now taking place. Studies of narrative reporting include "Rising to the challenge" recently published by the ASB. In addition, the FRC has been working with the FSA and contributed to the FSA recent discussion paper "Enhancing Disclosures by Credit Institutions".

The Auditing Practices Board and Professional Oversight Board have worked together on a number of generic publications aimed at improving audit quality. In November 2006 they published a discussion paper *Promoting Audit Quality* which resulted in the identification of five key drivers of audit quality which were published as an Audit Quality Framework in February 2008. In August 2010 they published *Auditor scepticism: Raising the bar* which discusses the degree of scepticism that auditors need to apply to conduct an audit to a high standard. The UK has also led a discussion with the leaders of the six largest global audit networks on the need for auditors to exercise greater scepticism and has challenged them to identify and take action to address its root cause.

During the financial crisis the FRC brought together a group of market practitioners to assist in the development of additional analysis and guidance about going concern and liquidity risk. This resulted in supplementary guidance in 2008 [Update for directors: Going concern and liquidity risk] that analysed the overlapping requirements of the Act, Listing Rules, Code and UK and IFRS Accounting Standards and Auditing Standards in the context of current events. Consolidating revisions were made to the FRC guidance on going concern in 2009.

Many have commented positively on the quality and timeliness of the additional guidance on going concern and liquidity risk, which was in part due to the quality of the interaction with market practitioners and all parts of the FRC. The FRC believes that there are opportunities to build on the benefits of those experiences.

It therefore proposes to create:

- A forum comprised of market practitioners supported by the FRC and UK Listing Authority to exchange views about current market developments on a regular basis. This would enable participants to share experience of developing best practice and also help to identify where the FRC as regulator could be a catalyst for improved practice through thematic studies and other outputs.

  Two groups could be envisaged. One addressing financial services businesses in which the FSA prudential team would also participate and the other looking at non-financial services. It would be appropriate for the groups to meet at least twice a year, possibly at the start of the planning season for the majority of interim reports and separately for the majority of Annual Reports.

- A 'financial reporting lab' where new financial reporting models and concepts could be explored, tested and trialled (without liability) to enable greater innovation in the market.

13 http://www.frc.org.uk/publications/pub1745.html

14 http://www.frc.org.uk/images/uploaded/documents/FRC%20Study%20-%20Accounting%20for%20acquisitions1.pdf

CHAPTER SIX:
THE LEGISLATIVE AND COST IMPLICATIONS OF THE FRC's PROPOSALS

In developing its proposals, the FRC has been conscious of the Government's approach to new legislation and regulation – and, in particular, its policy of not increasing the regulatory burden on companies unless there are clear benefits in doing so.

The FRC believes that the proposals that it has set out in this paper would require only minimal legislation to:

- remove certain statutory requirements that dictate how and where certain information is to set out in a company's Annual Report;
- provide for an investigation to be carried out in the event of a corporate failure into that company's governance, accounts, and audit; and
- extend the powers of the FRRP to include all aspects of a company's Annual Report.

The proposals would also require the development of Narrative Reporting Standards by the ASB.

The FRC recognises that there will be additional work and, therefore, cost as a result of the proposed:

- expanded report by the auditors to the Audit Committee; and
- Audit Committee report.

However, the FRC believes that the benefits in terms of increased confidence in corporate reporting outweigh the costs involved in such additional regulation.

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